



WATER ACT 2003
WATER SUPPLY LICENSING

**Modifications to water undertakers'
existing conditions of appointment**

**Conditions of water
supply licences**

Consultation paper

February 2004

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1 Introduction

1.1 Background

The Water Act 2003 (WA03) received Royal Assent on 20 November 2003. It amends the Water Industry Act 1991 (WIA91) to extend the opportunities for competition¹ in the water industry through the water supply licensing provisions (the licensing provisions). The changes provide a specific framework for access² to the public supply system within the England and Wales water industry. The licensing provisions were developed in the light of responses received to the Government's consultation paper: 'Extending Opportunities for Competition in the Water Industry in England and Wales' (July 2002).

We anticipate that from autumn 2005, industrial and commercial customers who are likely to consume at least 50 megalitres a year will be able to purchase water from either a statutory water undertaker³ or a licensed water supplier (a licensee). The implementation of this new regime will require the industry, Ofwat⁴, Department for Environment Food and Rural Affairs (Defra), the Drinking Water Inspectorate (DWI), the Environment Agency (EA) and the Welsh Assembly Government (the Assembly), as appropriate, to work together to ensure that an effective regime is delivered on schedule⁵. The extension of opportunities for competition will increase customer choice and should lead to keener prices, innovation and the provision of new and improved services to customers.

To enable the basic legislative framework to operate, the licensing provisions also provide for the issuing of secondary legislation and statutory guidance on specific matters.

In Ofwat's information paper 'Water Act 2003: Water supply licensing implementation process' (WSL 1/03), published on 5 December 2003 (the Information Paper), Ofwat set out its proposals for industry advisory groups to assist Ofwat and Defra in developing the details of the licensing provisions.

¹ In addition, the WA03 also amends legislation in respect of other issues, for example, provisions of the Water Resources Act 1991 relating to abstraction.

² The term 'access' refers to common carriage (the conveyance of water through the public supply system by a water undertaker on behalf of a licensee to supply the licensee's customer) and retail/wholesale supplies (the supply of water, purchased wholesale from the water undertaker, to the licensee's customer).

³ Water undertaker: A company appointed under the WIA91 to provide water services to a defined geographical area. The provisions in the WA03 only apply to water supplies and not the provision of sewerage services.

⁴ Under the WIA91 as amended by the WA03, the role of a single Director General of Water Services (the Director General) is replaced with the Water Services Regulation Authority (the Authority) which will be run by a Board. In anticipation of this change, Ofwat has already appointed an advisory board that includes independent non-executive advisory directors. For consistency and continuity, for the purposes of this consultation, the Director General and the Authority are referred to as Ofwat.

⁵ Section 52 WA03 places a duty on the Secretary of State, the Assembly, the EA and Ofwat to prepare a memorandum of understanding, with each of the others, to cover the co-operation and exchange of information between them and the consistency of treatment of matters which affect them. The agreed documents will be laid before Parliament.

1.2 Purpose

In order to implement the licensing provisions, we need to develop and formalise water supply licences (Water Supply Licences) with licence conditions and to modify water undertakers' existing conditions in their Instruments of Appointment. These are central to the implementation of the new competitive regime.

This consultation paper summarises our proposals for licence conditions for licensees and modifications to water undertakers' conditions of appointment. It forms part of the framework for implementing the licensing provisions and should be read in conjunction with Ofwat's Information Paper. The WIA91⁶ provides for the Secretary of State, in consultation with the Assembly, to determine licence conditions and for Ofwat to make the necessary changes to water undertakers' conditions of appointment. In practice Defra, the Assembly and Ofwat have worked together on both.

In preparing these proposals, our aim has been to avoid creating a regime that is too bureaucratic. We do not want to stifle competition with too much regulation. We are also mindful of the Government's wider objectives to:

- protect public health and ensure that the industry continues to deliver a safe and secure water supply;
- protect and improve the environment;
- meet the Government's social goals including affordability of water supplies; and
- safeguard services to customers.

We have aimed to strike a careful balance between these ideals. The Partial Regulatory Impact Assessment explains the options we considered and sets out the reasons for the approach we have taken. We consider that our proposals produce the right balance of clarity and flexibility.

We invite your views on our policy proposals. We will consult on drafts of both the licence conditions and the proposed modifications to conditions of appointment later in 2004. We expect the final versions to be published in summer 2005 when prospective suppliers will be able to apply for a Water Supply Licence, ahead of commencement of the overall regime in autumn 2005.

1.3 Structure of the paper

The rest of this paper is structured as follows.

- Section 2 outlines the main provisions of the WIA91 that relate to water supply competition.
- Section 3 outlines our proposals for modifying water undertakers' existing conditions of appointment and introducing new conditions.
- Section 4 outlines our proposals for licensing.

⁶ References to the WIA91 refer to the WIA91 as amended by the WA03.

1.4 Next steps

We invite your views on:

- our proposals to modify the existing conditions of appointment;
- our proposed new licence conditions for Water Supply Licences;
- additional issues that you think need to be accounted for, what these issues are and how they should be dealt with;
- whether our proposals are practical; and
- whether our proposals are likely to cause problems, what these problems are and how they can be resolved.

We have also identified specific questions in sections 3 and 4 of this paper. We welcome your views on these.

Please send your responses by 21 May 2004 to:

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Unless otherwise requested, all responses will be placed in the Ofwat library and made available to the public.

2 Water Industry Act 1991

This section outlines the main provisions of the WIA91 that relate to water supply competition.

2.1 Water supply licensing

The WIA91 permits access to a water undertaker's network so as to enable a licensee to supply water to eligible customers. Prospective suppliers will need to obtain a Water Supply Licence before they can compete with water undertakers in the supply of water through the public supply system. Prospective suppliers can either apply for:

- a 'retail' Water Supply Licence, which entitles the licensee to purchase water from a water undertaker (ie a wholesale supply) and to retail it to an eligible customer; or
- a 'combined' Water Supply Licence which enables the licensee to input water into a water undertaker's public supply system and to retail it to an eligible customer.

There are approximately 2,300 eligible customers spending in total approximately £200 million per annum on water (2002 figures). An eligible customer is defined as one whose premises are non-household and whose annual consumption at each relevant set of premises is likely to be not less than the defined eligibility threshold, currently set at 50 megalitres. Aggregation of volumes at different premises in order to meet the threshold is not permitted.

DWI has been granted extended powers under the new legislative provisions to audit licensees as well as water undertakers. The offence of supplying water unfit for human consumption (section 70 WIA91) has also been extended to ensure that all relevant persons concerned in the supply of water unfit for human consumption will be liable to prosecution. This will enable DWI to initiate proceedings against water undertakers, licensees and their respective contractors. DWI will also play an important role in the licensing process to ensure that applicants for a combined Water Supply Licence are technically competent.

The EA will continue to be responsible for regulating access to water resources, including managing the abstraction licensing regime. Defra, in consultation with the Assembly, may give directions to water undertakers in relation to their new water resource and management plans.

A Consumer Council for Water (CCW), independent of Ofwat, will replace the present WaterVoice arrangements. Its function will be to represent and protect the interests of all customers. Therefore, with regard to the new licensing regime, the CCW will represent the interests of both eligible and non-eligible customers.

Ofwat will have the power to make determinations to resolve disputes between water undertakers and licensees, on matters including access terms and charges and whether a customer is eligible. Ofwat will consult DWI where water quality issues

are involved. In making determinations, Ofwat will refer to the appropriate legislation and published guidance and its determinations will be legally enforceable. It would be prudent for water undertakers and licensees to attempt to resolve disputes between themselves, before asking Ofwat to make a determination. The guidance documents to be issued by Ofwat should minimise the need for determinations.

Ofwat, the EA and DWI will undertake a review of the licensing framework, including the eligibility threshold, within three years of the start of the licensing regime.

2.2 Application of the framework

The licensing provisions apply only to water supplied through the public supply system. The existing private supply arrangements will not be affected.

The licensing provisions relate primarily to potable water and to water undertakers' potable water supply systems. However, some water undertakers have separate discrete networks carrying non-potable water and these are also part of the licensing regime.

The licensing framework applies to water supplies and not the provision of sewerage services. Where a customer switches from a water undertaker that also provides a sewerage service, the water undertaker will continue to provide the sewerage service, unless other arrangements are made.

2.3 English / Welsh jurisdiction

Ofwat, DWI and the EA operate in both England and Wales. At present there are few significant differences between regulation in England and Wales. However, this may not always be the case and the licensing framework allows for differences between the two countries.

Where powers are devolved to the Assembly, water undertakers who operate wholly or mainly in Wales will remain subject to regulations made by the Assembly, whilst water undertakers who operate wholly or mainly in England will remain subject to regulations made by the Secretary of State⁷.

With respect to water quality, for example, licensees will be subject to the jurisdiction applicable to the water undertaker's supply system into which they are inputting water. Where the licensee is retailing water it will be subject to the jurisdiction applicable to the water undertaker's supply system from which its customer is supplied. If a licensee is operating in both England and Wales, this could mean that it would be subject to two sets of different controls.

⁷ In each case there will be a consultation between the relevant governmental bodies in the drafting of regulations.

2.4 Transitional arrangements

We anticipate that the new licensing regime will commence in autumn 2005, with potential licensees being able to apply for Water Supply Licences from summer 2005. Until commencement of the new regime, Ofwat will continue to regulate in accordance with the existing legislation.

2.5 Licensees

The Water Supply Licence will in most cases, authorise its holder to operate anywhere in England and Wales. Water undertakers will need to establish separate associated companies if they wish to apply for a Water Supply Licence. In such cases, the licensee will be prohibited from operating in its associated water undertaker's area of appointment. This is to protect the customers of the water undertaker from any potential adverse effects of the water undertaker pursuing competitive opportunities.

Once a Water Supply Licence has been granted, the licensee will be entitled to carry out the activities authorised by that Water Supply Licence subject to certain conditions (explained in section 2.6). For example, a 'retail' Water Supply Licence will allow retail activities and a 'combined' Water Supply Licence will allow common carriage and retail activities, as described in section 2.1.

A prospective supplier will need to provide Ofwat with information about its proposed activities. In particular, applicants who want to input water into a water undertaker's supply system will need to demonstrate technical expertise, for example relating to water treatment and quality. In considering the suitability of an applicant to hold a Water Supply Licence, Ofwat will consult DWI.

Applicants who intend only to retail water will not need to demonstrate such technical expertise because they will not have any operational involvement in the supply of water to customers. These applicants will still need to demonstrate financial and managerial competency.

2.6 Water undertakers

There are currently 23⁸ vertically integrated⁹ statutory water undertakers in England and Wales. Their main duties and responsibilities are set out in legislation and they must also comply with conditions that are set out in their Instruments of Appointment. Ofwat enforces compliance with these conditions.

Changes to Instruments of Appointment are made by Ofwat, either with the water undertaker's agreement or following reference by Ofwat to the Competition Commission on public interest grounds. However, the WA03 provides for

⁸ This excludes Albion Water Limited.

⁹ Vertically integrated water undertakers undertake every aspect of the provision of water services, ie ownership and control of the operation of abstractions, reservoirs, pumping stations, treatment works and all elements of the public water distribution network.

modifications to be made to water undertakers' conditions of appointment without reference to the Competition Commission provided the changes are necessary or expedient to implement the licensing regime (paragraph 4, schedule 4 WA03).

Under the new licensing provisions water undertakers will remain vertically integrated companies with responsibility for all elements in the water supply chain. They must however provide access to licensees under terms which comply with the licensing provisions of the WIA91 and associated Ofwat guidance. For example, charges for access must comply with the costs principle established by section 66E WIA91.

Water undertakers will have a duty to provide access to their supply systems whether for retail or combined purposes, subject to certain conditions. For example, the duty does not apply if it would put at risk the water undertaker's ability to fulfil its existing or future obligations as a statutory water undertaker, or where the premises supplied would contravene the Water Supply (Water Fittings) Regulations 1999, or where providing access would require water undertakers to incur unreasonable expenditure in carrying out the necessary works. Account will also have to be taken of any water quality issues that are likely to arise in providing access.

Water undertakers will remain responsible for water resource, emergency, drought and other incident planning (with regulation by the EA). In order to carry out this role effectively, licensees will be required to co-operate with water undertakers in carrying out these activities.

When carrying out their assessment of security of supply as part of their statutory duties, water undertakers will need to include both their own and licensees' water resources in their evaluation. There is no need for water undertakers to duplicate resources unnecessarily.

3 Conditions of appointment

This section outlines our proposals for modifying water undertakers' existing conditions of appointment and introducing new conditions.

3.1 Legislative provisions

Paragraph 4, schedule 4 of the WA03 gives Ofwat the power to modify water undertakers' conditions of appointment, as a result of the amendments to the WIA91 made by schedules 4 and 8 of the WA03, without recourse to the Competition Commission. Ofwat will consult separately on proposed modifications to water undertakers' conditions of appointment which are not related to the WA03¹⁰. This paper specifically explains the modifications required to implement the licensing provisions in the WIA91. Further changes will be required to the conditions of appointment as a result of different aspects of the WA03, such as those required to reflect the new WaterVoice structure, and will be consulted on separately in due course.

The modifications proposed in this section relate to the new duties on water undertakers to provide licensees with access to their networks.

3.2 Proposed modifications and new conditions of appointment

For the purposes of this paper, the existing conditions of appointment are described in brief and are listed in section 3.3. They are based on typical wording in water undertakers' Instruments of Appointment. Each water undertaker's conditions of appointment vary slightly as a result of various modifications agreed over time under the WIA91. Also, some water undertakers have certain conditions specific to their circumstances. We will take these factors into account before making any modifications to a water undertaker's existing conditions of appointment.

Where we are proposing to modify a condition, the proposed change has been highlighted in bold.

Where it is not practical to modify existing conditions, we are proposing to impose additional obligations on water undertakers in the form of new conditions of appointment. This paper also summarises those proposed new conditions (see section 3.4).

¹⁰ Some of these have been raised previously by Ofwat in for example MD174 (Consistency review of companies' licence conditions, 20 December 2001) and MD184 (Setting water and sewerage price limits for 2005-10: Framework and approach, March 2003).

3.3 Proposals for existing conditions of appointment

CONDITION A: INTERPRETATION AND CONSTRUCTION

This condition explains the terms and expressions used in the Instrument of Appointment. The condition will be amended to incorporate relevant new terms as defined in the Water Supply Licence. We will ensure that the new definitions are consistent with existing definitions.

STATUS: To be amended to include additional terms and their definitions.

CONDITION B: CHARGES

This condition allows Ofwat to limit increases in standard charges made by the water undertaker. The average increase is limited to the sum of the change in the retail price index over the previous year and an adjustment factor, called K. It provides for a review of all K factors by Ofwat at five-yearly intervals. Water undertakers have the right of appeal to the Competition Commission. This condition also requires each water undertaker to produce an annual principal statement so that Ofwat can verify that the water undertaker's tariffs are in line with its price limits, allowing Ofwat to approve every water undertaker's Charges Scheme (condition D).

Condition B also sets out the circumstances under which Ofwat (and the water undertaker) can request an interim determination to adjust K factors between periodic reviews. We will consult separately on proposed modifications to the interim determination mechanism and other aspects of condition B, which are not affected by the new licensing provisions or other provisions within the WA03.

This condition also contains provision for charges that are excluded from the tariff basket. We amended the appointments of all water undertakers to remove tariffs for customers using not less than 250 megalitres a year from the tariff basket with effect from 1 April 2000. The wording of the amended appointment condition allows for an automatic adjustment when the consumption threshold for inset appointments for large users is redefined.

Regulations to lower the threshold for inset appointments to customers of water undertakers in England using not less than 100 megalitres a year came into force on 17 August 2000¹¹. From April 2001 charges to customers of water undertakers in England supplied with not less than 100 megalitres of water a year (or sewerage customers supplied with not less than 100 megalitres of water a year) have been excluded from the tariff basket. These are treated as excluded charges.

Ofwat will consult separately on proposed modifications to the definition of 'excluded charges' in condition B to ensure that charges are excluded from the tariff basket in a way that is consistent with the provisions for competition in the WIA91¹². But the definition of 'excluded charges' in condition B will continue to refer to the inset threshold in section 7 WIA91, so that a lowering of the inset threshold will automatically affect the definition of 'excluded charges' (as it does now). It is the

¹¹ The 250 megalitres a year is retained in Wales.

¹² Ofwat's initial consultation was in RD25/03: Proposed modification of licence condition B, 27 June 2003.

Government's intention that the inset threshold (as it applies in England) should be lowered to reflect the eligibility threshold (and this will affect the definition of 'excluded charges' accordingly).

STATUS: Ofwat is consulting separately on proposed modifications to the definition of 'excluded charges' in condition B. This definition will however continue to be linked to the inset threshold, which in turn will be linked to the eligibility threshold. This, and other proposed modifications to condition B, are separate issues (and Ofwat will consult on them separately), not affected by the new licensing provisions.

CONDITION C: INFRASTRUCTURE CHARGES

This condition limits the amount and rate of increase in water undertakers' charges for the 'first time' provision of a water supply or sewerage service for domestic purposes.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION D: CHARGES SCHEME

This condition requires water undertakers to fix and publish charges for water and sewerage services and for infrastructure charges. This is done via a Charges Scheme which is submitted to Ofwat on an annual basis.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION E: PROHIBITION ON UNDUE DISCRIMINATION AND UNDUE PREFERENCE AND INFORMATION ON CHARGES

This condition applies to certain charges a water undertaker may levy for water supply and sewerage services. It imposes a duty on water undertakers to ensure that no undue preference is shown to, or that there is no undue discrimination against, any class of customers or potential customers in respect of standard charges. It also imposes a duty on water undertakers to ensure that no undue preference is shown to, or that there is no undue discrimination against, any customer or potential customer in respect of charges fixed by agreement. Ofwat may request information from a water undertaker in addition to that supplied under condition F to satisfy itself that water undertakers are complying with this condition.

Section 66D(3) WIA91 requires that charges payable by a licensee under the access agreement shall be fixed in accordance with the costs principle set out in section 66E WIA91. Provided that charges are set in this way, we think that they cannot be unduly preferential or unduly discriminatory. We are therefore not proposing any revision to the text of condition E.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION F: ACCOUNTS AND ACCOUNTING INFORMATION

This condition places a duty on water undertakers to provide accounting and other financial information. The condition also contains certain financial ring-fencing provisions, such as the provisions prohibiting cross-subsidy between Appointed and Non-Appointed Businesses to ensure all activities are on arm's length terms.

Water undertakers will need to establish separate associated companies if they wish to apply for a Water Supply Licence. This is to protect the customers of the water undertaker from any potential adverse effects of the water undertaker pursuing competitive opportunities. Water undertakers who want to compete outside their appointed area need to set up an associate company which is run independently to ensure that there are arm's length transactions between the regulated business and its associate licensees. We believe the current wording of this condition is sufficient to ensure that water undertakers trade at arm's length with licensees that are associate companies.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION G: CODE OF PRACTICE FOR CUSTOMERS AND RELATIONS WITH OFWAT

This condition requires the water undertaker to prepare and submit to Ofwat for approval, a Code of Practice which describes the services and charges to household customers, arrangements for bill paying and complaint handling, matters relating to water meters and what to do in an emergency.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION H: CODE OF PRACTICE AND PROCEDURE ON DISCONNECTION

All water undertakers have a Code of Practice on debt which is submitted to Ofwat for approval. The Water Industry Act 1999 amended the WIA91 to prevent water undertakers from disconnecting household customers. The code gives guidance to household customers who have difficulty in paying their bills. (We are consulting separately on a proposed modification to this condition, which is not the result of the new licensing provisions or other provisions within the WA03).

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no related modification.

CONDITION I: CODE OF PRACTICE AND PROCEDURE ON LEAKAGE

This condition requires water undertakers to prepare and submit to Ofwat for approval, a Code of Practice about the process for recalculating charges for household customers on a metered supply where there is an unidentified leak.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION J: LEVELS OF SERVICE INFORMATION AND SERVICE TARGETS

Water undertakers are required to maintain an efficient and economic system of water supply. They are required to provide Ofwat with an annual report setting out their performance against nine service standards (known as the DG indicators). This enables Ofwat to compare each water undertaker's performance with the rest of the industry.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION K: RING FENCING, DISPOSAL AND CHANGE OF USE OF PROTECTED LAND

This condition ensures that water undertakers retain sufficient rights and assets to enable a special administrator to manage the business to achieve the purposes of a special administration order. It also ensures that the best price is achieved from disposals of land so as to secure benefits for customers from the proceeds.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION L: UNDERGROUND ASSET MANAGEMENT PLANS

This condition requires the water undertaker to produce an underground asset management plan to show that it is maintaining and developing its underground assets necessary to fulfil its legal obligations.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION M: PROVISION OF INFORMATION TO OFWAT

This condition requires the water undertaker to provide Ofwat with information which may be reasonably required to carry out Ofwat's functions under the WIA91.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION N: FEES

This condition gives Ofwat the power to levy licence fees on the water undertakers sufficient to cover the running costs of Ofwat. Fees include the costs involved in undertaking periodic reviews and the costs of Competition Commission references. The fees are payable to Government (into the Consolidated Fund). Ofwat's costs are met from the Treasury.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no related modification. This condition might, however, need to be modified as a result of other provisions under the WA03 such as

the establishment of the Consumer Council for Water. Ofwat will consult on any such modification as a separate process.

CONDITION O: CIRCUMSTANCES IN WHICH A REPLACEMENT APPOINTMENT MAY BE MADE

Instruments of Appointment were granted from 1 September 1989. Generally a water undertaker can only be replaced after 25 years' notice of termination from the Secretary of State. The WIA91 permits other changes by agreement or to cover inset appointments.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

CONDITION P: UNDERTAKING FROM HOLDING COMPANY

This condition applies to water undertakers which are part of a multi-utility or other large commercial group. The undertaking from the parent company to the water undertaker ensures that group companies (other than the water undertaker itself and its subsidiaries) provide the water undertaker with the information necessary to comply with its conditions of appointment and ensures that those companies refrain from any action which would cause the water undertaker to be in breach of those conditions or of relevant legislation.

If a water undertaker wishes to apply for a Water Supply Licence, a separate associated company will need to be established. An associated licensee will be part of the group's business and the undertaking from the parent company will apply to the licensee provided it is not a subsidiary of the water undertaker.

We do not consider that a modification to condition P is necessary. Whether a water undertaker has condition P or not, where an associated licensee is established as a subsidiary of the water undertaker, we would in any case be able to take enforcement action under section 18 WIA91 against the water undertaker where it was in breach of its conditions or of relevant legislation (or was likely to be in breach).

We will consult separately on whether all statutory undertakers should have condition P¹³ as this raises issues beyond the licensing provisions.

STATUS: We will consult separately on whether all statutory water undertakers should have condition P in their appointment conditions.

Q1: We would welcome views as to whether you agree that condition P (for those companies that have it) does not require modification in respect of the licensing provisions.

¹³ Ofwat's initial consultation was in MD174 (Consistency review of companies' licence conditions, 20 December 2001) with responses to the consultation reported in MD181 (Consistency review of companies' licence conditions, 3 October 2002).

CONDITION Q: INTERRUPTIONS IN SUPPLY BECAUSE OF DROUGHT

This condition requires water undertakers to pay compensation to business and household customers if their supply is interrupted or cut off under the authority of a drought order.

This condition currently provides for payment of compensation. It does not specify how water undertakers should inform their customers of a drought (this is covered in the Water Resources Act 1991).

We considered modifying condition Q so that the water undertakers' duties extended to providing compensation payments to the licensee's customers. However, we believe that passing on compensation payments to the end customer is a matter best dealt with under contractual agreements between a licensee and its customers and similarly, under the access agreement between a water undertaker and a licensee. Unlike customers, licensees will have negotiated an agreement with the water undertaker so the two parties should decide the level of risk involved and agree reasonable terms for compensation payments.

Unlike households, eligible customers will negotiate contract terms with the licensee and agree whether/how much compensation is paid.

STATUS: This condition will be unaffected by the licensing provisions and therefore requires no modification.

3.4 Proposed new conditions of appointment

CONDITION [R]: PROVISION OF COMMON CARRIAGE AND WHOLESALE SERVICES

This new condition supports sections 66A – 66C WIA91 (ie the duties on water undertakers associated with the provision of access services to licensees, on reasonable terms).

Sections 66A - 66C WIA91 set out the duties on a water undertaker for the provision of access services to a licensee to enable the licensee to supply its eligible customers. These new sections also set out the conditions under which these duties do not apply. Where a water undertaker permits access, this should be in accordance with terms agreed with the licensee (in accordance with relevant statutory guidance) or determined by Ofwat under section 66D WIA91.

Section 66D WIA91 provides for the determination by Ofwat of the terms and conditions under which a water undertaker is to perform any duty under sections 66A – 66C WIA91. 66D(3) WIA91 requires the charges payable by licensees under an agreement with the water undertaker or a determination by Ofwat, to be fixed in accordance with the costs principle set out in section 66E WIA91.

66D(4) WIA91 requires Ofwat to issue guidance in accordance with which the terms and conditions of agreements, including the fixing of charges, between water undertakers and licensees shall be made. Sections 66D(7) and 66D(8) WIA91 allow Ofwat to require the parties to such agreements to modify or terminate agreements

which are not made in accordance with that guidance or with the costs principle referred to in section 66E WIA91. This requirement is enforceable using section 18 WIA91.

Water undertakers must comply with Ofwat guidance (section 66D(4) WIA91) and specify in their access agreements what is required from licensees in terms of information on customers, water quality and other matters.

The access code guidance will be developed by Ofwat in conjunction with the industry advisory groups, and will include terms that will not be specific to a single access agreement. This condition is intended to ensure that all supply licensing issues that are not dealt with in the guidance or have not been provided for in the WIA91, are dealt with in this condition. The contents of this condition will therefore, to a certain extent, depend on discussions by industry advisory representatives regarding the access code guidance.

This condition is intended to ensure water undertakers:

- produce and publish a code for access (including prices) and keep it updated;
- do not unfairly discriminate between licensees (or their customers) and a water undertaker's other customers; and
- (or their associates) do not obtain an unfair commercial advantage as a result of their activities under this condition.

Proposed condition to have the following effects.

1. As part of demonstrating active co-operation in providing access, water undertakers will be required to produce and publish a code for access and to comply with this code in offering terms and conditions (including prices) to licensees. In producing the code, water undertakers are obliged by the WIA91 to follow Ofwat's guidance.
2. Water undertakers must keep their access codes under review and publish any changes to them. They must also send a copy of their code to Ofwat at least annually and in the event of any changes to it, and provide a copy to anyone on request.
3. In carrying out their obligations under this condition, water undertakers are required not to show undue preference towards, or undue discrimination against or between any customer connected to its network regardless of whether supplied by the licensee or the water undertaker.

A water undertaker cannot expect a licensee's customers to behave differently to its own customers. For example, in circumstances where there is a drought order or hosepipe ban, a water undertaker should not expect the licensees' customers to

have to limit their water use in preference to limiting water use by its own customers.

This condition will be based on the understanding that the licensing provisions in the WIA91 (sections 66D and 66E) require that water undertakers should not discriminate between providing any access services to themselves and to licensees, or between different licensees (or their customers). We consider that this is integral to the licensing provisions and therefore does not need to be covered in a condition of appointment.

4. In providing access services under this condition, a water undertaker must ensure that neither it, nor any related person nor any body corporate in which that water undertaker or a subsidiary of it has a participating interest, obtains any unfair commercial advantage. For example, the water undertaker may have access to confidential information relating to a licensee's activities which it might be able to use to gain an unfair commercial advantage.
5. In providing access under this condition, water undertakers will need to obtain information from licensees. Information may include details of customers supplied by the licensee; its water sources; water quality; volume and timing of water to be supplied; the security of supply associated with the licensees' water services; and meter reading details.

Water undertakers are required to request only information that they reasonably require in order to carry out their functions.

Nothing in this condition will require water undertakers to breach their statutory duties and responsibilities to their existing customers, including the operation of their supply system.

Q2: Do you think this condition goes far enough to support the licensing provisions in the WIA91?

Q3: Are there any issues which we are proposing for this condition that would be better dealt with in access agreements? If so, please identify these issues and provide explanations of your arguments.

CONDITION [S]: THE REGISTRATION AND TRANSFER PROTOCOL

In order to ensure a smooth transfer when customers move from a water undertaker to a licensee, as well as between licensees, a customer transfer / data management protocol (the Transfer Protocol) will need to be in place.

The Transfer Protocol will guide water undertakers and licensees on the steps that need to be followed before, during and after a customer switches water supplier, such as the stages involved; the responsibilities of the relevant parties; notification details; and timing issues. These issues will be discussed by the industry advisory groups and consulted on separately.

We are proposing that water undertakers and licensees should be required to cooperate in the production of a Transfer Protocol which will be approved by Ofwat. Water undertakers and licensees will be required to abide by the terms of the Transfer Protocol once it has been established.

There will be a similar requirement on licensees, via a standard licence condition (see section 4.5).

Proposed condition to have the following effects:

1. water undertakers will be required to abide by the terms of the Transfer Protocol once it has been established;
2. where, following its implementation, water undertakers and/or licensees wish to modify part of the Transfer Protocol, they may propose amendments to Ofwat. Before revising the Transfer Protocol, Ofwat will consult, where appropriate, on proposed substantive modifications. Ofwat will have the power to veto proposed changes.

Q4: Do you think this condition goes far enough to ensure the smooth transfer of eligible customers?

Q5: What issues do you think need to be set out in this condition regarding the transfer of customers?

3.5 Other issues

In addition to the proposals highlighted in sections 3.3 and 3.4, we considered including conditions relating to metering and pipelaying in water undertakers' Instruments of Appointment.

However, in the light of the provisions contained in the WIA91 we do not think that such conditions would be appropriate. Rather than developing new conditions we consider that it would be better to deal with these issues in an access agreement. Our reasons for this are set out below.

Pipelaying

We considered whether a new condition concerning pipelaying was necessary for water undertakers. Sections 51A to 51E of the WIA91 contain provisions concerning pipelaying, requiring water undertakers to adopt pipes laid to an appropriate standard by licensees and allowing water undertakers to recover reasonable costs of pipelaying associated with licensees' activities. Under the WIA91, licensees will therefore be able to choose whether to lay the pipes themselves or ask the water undertakers to install them.

We believe the access agreement would be the best place to cover the issue of reasonable timetables for water undertakers to respond to licensees' pipelaying requests.

Metering

Section 205 of the WIA91 provides for the exchange of meter readings between the relevant water undertaker and the licensee.

We considered the option of having a condition on metering in the Instrument of Appointment. This could cover instances where for example, the licensee has taken responsibility for reading the meter. In order to prevent the water undertaker from continuing to read the meter and charge the licensee for this service, we considered whether there should be a condition requiring the water undertaker to accept the licensee's meter readings.

However, we consider that it would be more appropriate that arrangements for metering between the licensee and the water undertaker will be governed by the access agreement.

4 Water Supply Licence

This section outlines our proposals for licensing.

4.1 Legislative provisions

As explained in section 2, licensees will have their own Water Supply Licence, which will differ from water undertakers' Instruments of Appointment. The licensing provisions make specific provision for the activities to be provided for, and the conditions to be contained in, the Water Supply Licence.

Section 17A WIA91 establishes the licensing of new water suppliers and sets out the basis on which licensees can supply customers. A licensee will either be granted a 'retail' Water Supply Licence or a 'combined' Water Supply Licence. (See section 2.1 for details).

Sections 17G and 17H WIA91 provide, respectively, for Water Supply Licences to include conditions and for the Secretary of State, in consultation with the Assembly, to determine 'standard conditions'.

In particular, section 17G WIA91 provides for, amongst other things:

- such conditions as appear to the Secretary of State or Ofwat to be requisite having regard to duties imposed on him or it under Part 1 of the WIA91; and
- conditions requiring the rendering to the Secretary of State of a payment on the grant of a Water Supply Licence, and/or payments while it is in force, of amounts determined under the conditions.

Section 17H WIA91 provides for standard conditions of Water Supply Licences to be determined by the Secretary of State, in consultation with the Assembly. Standard conditions ensure that all Water Supply Licences of a particular type contain the same conditions as far as is appropriate. They can also be modified collectively.

Within these legislative parameters, there is a certain degree of flexibility as to what form the Water Supply Licence may take.

4.2 Preparation of the standard licence conditions

In preparing draft Water Supply Licence conditions we have considered two models: the water undertakers' Instruments of Appointment and supply licences in the gas and electricity industry.

A retail Water Supply Licence will exclude standard conditions that relate to common carriage activities. It is likely that the standard conditions relating to retail activities will be the same for both a retail Water Supply Licence and a combined Water Supply Licence.

Section 17H(6-8) WIA91 allows the Secretary of State or Ofwat, when granting a Water Supply Licence, to exclude or modify any of the standard conditions of a particular Water Supply Licence as appropriate to meet that licensee's circumstances. Before doing so, the Secretary of State or Ofwat is required to consult on the exclusions or modifications. They will give notice of their intentions, setting out the impact of, and the reasons for, the exclusions or modifications and allowing for representations to be made.

4.3 The Water Supply Licence: an overview

The Water Supply Licence will state the licensee's name, address and registration number and the activity authorised (retail or combined). The Water Supply Licence will specify the date on which it comes into force and it will continue in force until it is revoked (see section 4.4 for details on revocation).

Each Water Supply Licence will list the standard conditions applicable to the authorisation granted. These will be standard licence conditions (detailed in section 4.5) and will be listed in the Water Supply Licence, but not set out in full. The full standard licence conditions will be incorporated by reference and published separately.

Section 17I WIA91 sets out the procedure by which Ofwat can modify the conditions within a particular Water Supply Licence, with the consent of the licence holder. This procedure includes standard licence conditions, however there are safeguards to ensure such modifications do not unduly disadvantage other licence holders.

Section 17J WIA91 describes the circumstances in which Ofwat may modify standard licence conditions. Modifications may take place where no licence holder objects to the modification or where specified percentages of licensees vote to support it. These percentages will be specified by order and based on the number of relevant licence holders and their respective market shares.

In addition, section 17J WIA91 provides that Ofwat may modify a standard licence condition where the modification is reducing a burden on licence holders in carrying out their activities, provided that no licence holder is unduly disadvantaged as a result. This circumstance is quite distinct from those set out above, however Ofwat will be obliged to consider any representations or objections which are made whenever it gives notice of a modification.

Before making any modifications under sections 17I and 17J WIA91, Ofwat must give the relevant notices to any persons likely to be affected by the making of the modification. A copy of the notice will be served on each relevant licence holder, the CCW, the Secretary of State, the Assembly, and DWI. The notice will specify the time within which representations or objections with respect to the proposed modifications may be made.

Section 17K WIA91 sets out the procedure for Ofwat to refer proposed modifications of licences to the Competition Commission. Ofwat can refer proposed modifications to the Competition Commission, effectively asking it to consider the extent to which

the proposed modification addresses matters which operate, or may operate, against the public interest. This includes modifications to the conditions of particular Water Supply Licence or the standard conditions. This is expected to be used if there are relevant objections to a modification to either the conditions of a particular Water Supply Licence or the standard conditions proposed by Ofwat.

Where standard licence conditions are modified collectively, it will not be necessary to amend each Water Supply Licence individually. The modification will apply automatically to each Water Supply Licence which is subject to the modified standard conditions. In addition, it will also be possible to modify the standard licence conditions in individual cases. Any such modifications will be written out in full in the Water Supply Licence.

4.4 Conditions of the Water Supply Licence

REVOCAATION

All Water Supply Licences shall contain a condition describing the circumstances in which such licences may be revoked. We have been considering how revocation issues should be dealt with. The two options are:

1. a condition under section 17G(1)(a) WIA91. In this instance, revocation would be subject to the modification process under sections 17I and 17K WIA91 (as explained in section 4.3); or
2. a standard licence condition which would be subject to the modification process under sections 17I, 17J and 17K WIA91 (as explained in section 4.3).

The main difference between these two options is that where the revocation condition is not a standard licence condition, Ofwat will only be able to modify it with the agreement of the individual licence holder under section 17I WIA91 (or by reference to the Competition Commission under section 17K WIA91).

All Water Supply Licences may be revoked after the expiry of a notice period of at least 25 years.¹⁴ This is in line with condition O in relation to water undertakers' Instruments of Appointment.

There will not be a requirement for consultation before the issue of a revocation notice, given the length of the notice period. Any notice would be likely to be issued as a result of a change in Government policy resulting in industry restructuring and licensees would have full opportunity to make representations in the light of consultation on that policy.

However, there may be circumstances where the 25-year notice period would be too long. Therefore, provisions will specify other circumstances where revocation may take place over a much shorter period. Ofwat will be able to revoke a Water Supply

¹⁴ The period of 25 years was consulted on in 'Extending opportunities for competition in the water industry in England and Wales', July 2002.

Licence in the specified circumstances at any time by giving notice in writing to the licensee. Normally the notice period will be not less than 30 days.

The proposed circumstances in which Ofwat will be able to revoke a Water Supply Licence following the shorter notice period of not less than 30 days will include:

- a request to do so by the licensee;
- false or misleading statements made by the licensee to Ofwat or DWI;
- failure by the licensee to pay all or any part of the licence fee;
- failure by the licensee to comply with either a final or provisional enforcement order;
- failure by the licensee to pay any financial penalty by the date for payment;
- if the licensee has not started to supply water to premises within three years of the coming into force of the Water Supply Licence or, having supplied premises, has not done so for a period of three consecutive years. This may offer some protection to restrict the influence licensees may have over the modification of standard licence conditions if they themselves are not active in the market;
- if the licensee has debts that it cannot pay, has a receiver appointed in respect of all or a material part of its assets; has an administration order made against it; passes a resolution for winding-up (other than one previously agreed in writing by Ofwat); or becomes the subject of a winding-up order by the High Court;
- if the licensee is in breach of condition 7 (Area of operation – see section 4.5).

In each case, revocation will only take place if, in appropriate circumstances, there has been an orderly exit from the market. This may include the proper transfer of customers. For example:

- if strategic supplies are controlled by a combined licensee, the special administration regime set out in the WIA91 will apply and the Water Supply Licence will not be revoked until this has been completed;
- a combined licensee may have to ensure that certain technical conditions are met before it can stop introducing water into a water undertaker's supply system. These may relate to the effective and sanitary closure of pipes or treatment works; and
- in some circumstances, a combined or retail licensee may be obliged to comply with the Transfer Protocol before the Water Supply Licence is revoked.

Q6: You are invited to comment on the proposed reasons for revocation to be set out in the Water Supply Licence.

Q7: Should revocation issues be dealt with as a condition which would be subject to the modification process detailed in sections 17I and 17K WIA91? Or, should revocation issues be dealt with by means of a standard licence condition which would be subject to the modification process detailed in sections 17I and 17K WIA91 as well as the collective modification process detailed in section 17J WIA91?

4.5 Standard licence conditions of the Water Supply Licence

CONDITION 1: PAYMENTS TO OFWAT

Section 17G WIA91 allows for payment of a licence fee on the grant of a Water Supply Licence, and/or payments while such a licence is in force.

The level of fee will not be determined in the licence conditions although the formula for calculating it will be. Fees will be set at a level to recover Ofwat's, the CCW's and the Competition Commission's costs in regulating the competitive market.

The amounts determined under this condition will be payable in one instalment with at least 30 days' notice of payment given. Ofwat will collect the sums on behalf of the Secretary of State.

CONDITION 2: CONDUCT OF LICENSEE

This condition will require licensees to act in a reasonable manner in the use they make of the water undertaker's supply system for the conveyance of water in accordance with their access agreements.

For example, licensees' behaviour with regard to putting water into the network will be set out in access agreements with water undertakers. Access agreements must conform to Ofwat's statutory guidance which should ensure appropriate conduct by licensees. Enforcement action will be possible in the event of disruption to a water undertaker's supply system as a result of breaches by licensees of access agreements. However, this condition should not be formulated so that it is invoked by every breach of an access agreement regardless of its impact. This licence condition should also not prejudice particular terms of access agreements. However, general or persistent breaches of a specified type should constitute a breach of this condition.

This condition will give general regulatory oversight over licensees' access to the public supply system. A new combined licensee would not have been allowed to introduce water into a water undertaker's supply system until DWI was satisfied that the technical management of its source and treatment works met the relevant regulatory requirements. In addition, we consider that further enforcement action under this condition will be taken where a licensee by act or omission does something which is likely to prejudice the:

- safe and economic operation by water undertakers of their supply systems on a day to day basis;
- efficient balancing of the supply system by the water undertaker;
- the proper functioning of access and wholesale arrangements; or
- the quality of water conveyed through the system.

DWI will take enforcement action for any breaches of statutory duties relating to drinking water quality. DWI will inform Ofwat when such action is being taken and this could eventually result in a Water Supply Licence being revoked.

This licence condition could also extend to making false statements about the amount of water a licensee puts into or takes out of the supply system.

Section 18 WIA91 (Orders for securing compliance with certain provisions) deals with enforceability against the licensee in the event that the licensee causes or contributes (or is likely to cause or contribute) to a problem which leaves the water undertaker open to enforcement action. If a licensee does act in this way Ofwat is under a duty to take enforcement action.

Although most of these issues are provided for in legislation and will be covered in access agreements, we believe that this condition is necessary for instances where the licensee continuously fails to meet its contractual obligations. Ofwat might for example need to revoke the Water Supply Licence and this condition allows Ofwat to do this.

Q8: Do you think this extra level of enforcement is necessary?

Q9: In what sort of instances do you consider this extra level of enforcement might be used?

Q10: Do you think this condition would interfere with contractual arrangements between licensees and water undertakers?

Q11: How might the condition be formulated to avoid any interference with contractual arrangements between licensees and water undertakers?

Q12: How might the general or persistent breaches be specified?

CONDITION 3: GENERAL INFORMATION PROVISION TO WATER UNDERTAKERS

This condition will ensure that, where the water undertaker makes a reasonable request for information, the licensee must comply with this request. A water undertaker might request information from a licensee for the purpose of:

- fulfilling its statutory functions;
- fulfilling its obligations under its Instrument of Appointment;
- securing adequate quality of water entering the water undertaker's supply system;

or

- complying with requests for information which are made by the EA.

Licensees will be required to provide such information to water undertakers, provided it is in their possession or is readily available.

Licensees should be able to refuse to provide information where its disclosure would seriously and/or prejudicially affect the licensee's commercial interest. In such cases Ofwat will be able to direct (using powers in this condition) the provision of an item of information on the grounds that it is necessary or expedient in order for the water undertaker to fulfil its statutory function. There will be protection for legally privileged information.

There are other instances where a water undertaker may request information from a licensee. There are provisions in the WIA91¹⁵ that will require licensees to provide water undertakers with information regarding water resource, emergency and drought planning. The duty to provide such information will be enforceable under the WIA91 and therefore does not need to be covered in a standard licence condition.

Q13: Do you consider this information condition goes too far or not far enough in protecting the water supply network?

CONDITION 4: PROVISION OF INFORMATION TO OFWAT

Ofwat needs to be able to collect information from licensees in order to be able to fulfil its functions. Licensees will be placed under an obligation to provide Ofwat with such information and reports as Ofwat may reasonably require or as may be necessary to fulfil its functions under the WIA91.

This is similar to condition M of water undertakers' appointments (see section 3.3). Ofwat will require this information to be provided in such manner and at such times as it deems fit. Ofwat will have separate powers to require the provision of information in order to exercise its functions under section 27 WIA91 and to carry out enforcement action (section 203 WIA91).

This condition will also require licensees, if requested to do so by Ofwat, to give reasoned comments on the accuracy and text of any information or advice relating to its activities as a licensee which Ofwat proposes to publish under section 201 WIA91.

CONDITION 5: CERTIFICATE OF ADEQUACY

In applying for a Water Supply Licence, a licensee has to show it has the necessary management, financial, operational and technical resources to carry out its proposed activities in accordance with its statutory and contractual obligations. DWI will advise Ofwat in respect of operational and technical competence.

This condition will require an annual submission of a certificate of adequacy (signed by the Directors of the company) confirming that a licensee has the ongoing

¹⁵ The new emergency directions provided for under section 208 WIA91.

management, technical and operational resources to carry out the activities in which it is engaged and which it demonstrated at the application stage.

When a change occurs which may affect a licensee's ability to comply with the conditions of its Water Supply Licence, or when it changes between combined and retail only activities, this condition will oblige a licensee to submit a further certificate of adequacy (together with an explanation of the change).

Where the licensee becomes aware of an actual or possible event which would prevent it from being able to submit a certificate of adequacy at any time, the licensee will be obliged to notify Ofwat of that fact as soon as practicable.

The criteria that a licensee should be required to meet at the application stage will be discussed by the licensing and eligibility industry advisory group. The industry advisory group will also look at and advise on the format of the certificate of adequacy (see Ofwat's Information paper for further details about industry advisory groups).

Q14: You are invited to comment on the merit and possible extent of the proposed certificate of adequacy.
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CONDITION 6: THE REGISTRATION AND TRANSFER PROTOCOL

In order to ensure a smooth transfer when customers move between a water undertaker and a licensee, as well as between licensees, a customer transfer / data management protocol (the Transfer Protocol) will need to be in place.

The Transfer Protocol will guide water undertakers and licensees on the steps that need to be followed before, during and after a customer switches water supplier, such as the stages involved; the responsibilities of the relevant parties; notification details; and timing issues. These issues will be discussed by the industry advisory groups and consulted on separately.

We are proposing that water undertakers and licensees should be required to co-operate in the production of a Transfer Protocol which will be approved by Ofwat. Water undertakers and licensees will be required to abide by the terms of the Transfer Protocol once it has been established.

There will be a similar requirement on water undertakers, via new condition [S] (see section 3.4).

Licensees will be required to:

1. abide by the terms of the Transfer Protocol once it has been established;
2. where, following its implementation, water undertakers and/or licensees wish to modify part of the Transfer Protocol, they may propose amendments to Ofwat. Before revising the Transfer Protocol, Ofwat will consult, where appropriate, on proposed substantive modifications. Ofwat will have the power to veto proposed changes.

Q15: Do you think this condition goes far enough to ensure the smooth transfer of eligible customers?

Q16: What issues do you think need to be set out in this condition regarding the transfer of customers?

CONDITION 7: AREA OF OPERATION

The Water Supply Licence will make clear that the licensee will be excluded from operating in the area of appointment of any water undertaker with which it is associated. This condition will include an obligation on the licensee to notify Ofwat of any change of ownership or control that could affect this exclusion.

Q17: You are invited to comment on whether you agree that this should be drafted as a standard condition rather than as an individual condition.

CONDITION 8: SPECIAL ADMINISTRATION AND SECURITY OF SUPPLY

Where a licensee who holds a combined Water Supply Licence inputs a significant amount of water into a water undertaker's network and the withdrawal of that input through insolvency may put at risk the water undertaker's duty to supply for domestic purposes, the particular input may be designated as being a strategic supply. Strategic supplies are an introduction of water without which there would be a substantial risk that the water undertaker would not be able to maintain supplies to its own customers and make supplies for domestic purposes to a licensee's customers.

The designation of strategic supplies means that the licensee would go into special administration rather than normal winding up procedures should this be warranted. The special administrator would ensure that strategic supplies continued to be input to the supply system.

Under section 66G WIA91 (Designation of strategic supply), a water undertaker can request Ofwat to make a determination that an introduction of water constitutes a strategic supply. Ofwat may also propose to make such a determination without any request.

We consider that a standard licence condition is required for licensees whose supply has been designated as strategic to enhance the strategic supply and special administration protections provided for in legislation such as those regarding disposal of assets.

This condition would ensure that if a licensee was subject to a special administration order, the licensee would have available to it sufficient rights and assets (other than financial resources) to enable the special administrator to manage the affairs, business and property of the licensee.

Q18: Do you think this condition goes far enough to enhance the strategic supply/special administration protections provided for in legislation?

4.6 Other issues

In addition to the proposals in sections 4.4 and 4.5, we considered incorporating into the Water Supply Licence the following conditions; information to customers; obligation to follow guidance on supply contracts; and an obligation to comply with arrangements in water undertakers' drought and water resource plans.

However, in the light of provisions contained in the WIA91, we do not think that these issues should be covered in standard licence conditions. Rather than developing new conditions we believe that it would be better to deal with these issues in access agreements or in contracts with customers. The reasons for our conclusions are set out below.

Information to customers - code of practice

We considered the option of including a standard licence condition requiring licensees to provide customers with certain information in codes of practice.

Water undertakers do not have a similar obligation to provide non-domestic customers with codes of practice. We do not want licensees to be subject to tougher requirements than water undertakers so we do not think it would be appropriate to compel licensees to submit a code of practice.

Potential customers of a licensee can negotiate appropriate information provisions as part of their contract.

Q19: Do you think there are reasons why a condition of this type might be necessary? How could any concerns be dealt with in a standard licence condition?

Obligation to follow guidance on contract terms

We considered the option of including a standard licence condition to ensure that certain basic provisions were included in licensees' supply contracts with customers, for example, to ensure that licensees did not enter into a contract for the retail of water to any premises unless the contract provided for termination within a certain time period.

However, given that eligible customers will be large users, we expect that they should be able to negotiate appropriate contractual terms with the licensee without reference to a licence condition.

Q20: Do you think there are reasons why a condition of this type might be necessary? How could any concerns be dealt with in a standard licence condition?

Complying with arrangements in water undertakers' drought or water resource plans.

We considered the option of including a standard licence condition to require licensees to comply with arrangements or undertakings set out in water undertakers'

drought or water resource plans. Such a condition would require a licensee to use its best endeavours to comply with all reasonable requests by water undertakers for the purpose of:

- securing adequate supplies of water when under drought orders; or
- facilitating the water undertakers' compliance with directions in times of drought.

We do not consider such a condition is necessary. Drought or water resource plans are enforceable against the water undertaker, so the water undertaker can include the obligations referred to above in its access agreement with the licensee. We believe these issues are better placed in access agreements.

Q21: Are there any reasons why a condition of this type might be necessary? How could any concerns be dealt with in a standard licence condition?

Securing compliance in group companies_

In respect of group companies, certain water undertakers are responsible for securing undertakings from their parent companies to the effect that activity by an associate company should not cause the water undertaker to breach its appointment or obligations under relevant legislation (see condition P in section 3.3). As mentioned under condition P, where water undertakers do not have condition P, we can in any event take enforcement action for breach under section 18 WIA91. We can also take enforcement action where a water undertaker causes a licensee to be in breach (section 18 (1A)(a) WIA91).

Similarly we can take enforcement action against any licensee which is in breach (section 18(1) WIA91) or which causes a water undertaker to be in breach (section 18(1A)(b) WIA91).

In the light of the above, we do not think that a licence condition which stipulates that a licensee must not cause the water undertaker to be in breach of its conditions or of relevant legislation is necessary as we already have a right of enforcement under primary legislation.

Q22: Do you believe that it is necessary to place a condition on licensees which is similar to condition P?

Q23: Do you believe that such a condition should be imposed on a licensee where it has an associated water undertaker which does not have condition P?

Partial Regulatory Impact Assessment

1. Purpose and intended effect of the policy and its timing

This consultation forms part of the framework for implementing the licensing provisions of the WIA91. The licensing provisions provide a specific framework for 'access' to the public supply system (common carriage and retail/wholesale supply competition) within the England and Wales water industry.

The WIA91 permits access to a water undertaker's network so as to enable a licensee to supply water to eligible customers. Prospective suppliers will need to obtain a Water Supply Licence before they can compete with water undertakers in the supply of water through the public supply system. Prospective suppliers can either apply for:

- A 'retail' Water Supply Licence, which entitles the licensee to purchase water from a water undertaker (a 'wholesale supply') and retail it to an eligible customer.
- or
- A 'combined' Water Supply Licence which enables the licensee to input water into a water undertaker's public supply system and to retail it to an eligible customer.

There are approximately 2,300 eligible customers spending in total about £200 million on water per annum (2002 figures). An eligible customer is defined in the WIA91 as one whose premises are non-household and whose annual consumption at each relevant set of premises is likely to be not less than the defined eligibility threshold, currently set at 50 megalitres.

The purpose of the consultation paper is to invite your views on our policy proposals. Responses to the consultation will assist in the development of new conditions for licensees and the modifications to water undertakers' conditions in their existing Instruments of Appointment. The main changes to water undertakers' conditions of appointment will be in the form of two new conditions. These new conditions will ensure that water undertakers publish an access code and keep it under review and also that they comply with a Transfer Protocol. We will consult on the legal version of the proposed modifications to water undertakers' conditions of appointment and the standard licence conditions later this year. We expect the final licence conditions and conditions of appointment to be published in summer 2005. Prospective suppliers will be able to apply for a Water Supply Licence in summer 2005, with the overall regime due to commence in autumn 2005.

In order to protect water quality and to promote competition, there need to be rules and procedures to govern how water undertakers will provide access to their networks. Although relevant standards have to be met, these rules should not be so burdensome on water undertakers and licensees that they deter competition. In setting such relevant standards, a balance would need to be struck with wider objectives for the water industry to ensure that whilst they are not overly

burdensome, they do not create unnecessary risks in other areas, such as public health.

There will need to be an access agreement between the licensee and the water undertaker to govern arrangements between the two parties. Section 66D(4) WIA91 requires Ofwat to publish guidance in accordance with which the terms and conditions of such agreements shall be made.

We need to strike a balance between issues that are governed by an access agreement and obligations we need to impose on water undertakers and licensees by means of conditions of appointment and standard licence conditions respectively.

Due to the complex nature of this regulatory regime, and the difficulty in predicting how a competitive market will develop and behave, the assessment of costs and benefits included in this Regulatory Impact Assessment (RIA) is mainly qualitative. Although there will be a degree of fixed costs associated with the start up of competition, we expect that the scale of these will be limited because of the size of the initial market. Over the longer term however, we expect that the extent and magnitude of costs and benefits will depend more on the number of new entrants and the level of competitive activity in the market.

The focus of this RIA is on how the new licensing provisions will affect undertakers' conditions of appointment and the Water Supply Licence for licensees. The wider regulatory impact of the extension of competition in the water industry was dealt with in the RIA to the Government consultation paper 'Extending Opportunities for Competition in the Water Industry in England and Wales' (July 2002).

2. Options and Rationale

2.1 Modifications to water undertakers' conditions of appointment

Paragraph 4 of schedule 4 WA03 allows Ofwat to modify conditions of appointment where it considers it necessary or expedient to do so in consequence of the amendments to the WIA91 made by schedules 4 and 8. In considering how to achieve this, we have sought to attain a suitable balance between what is placed in water undertakers' conditions of appointment and what is contained in our guidance on access terms and conditions. Given the provisions in the WIA91, we have identified and considered 3 options.

1. Do nothing – make no changes to water undertakers' conditions of appointment. There is no statutory requirement for us to modify water undertakers' conditions of appointment.
2. Make minimal changes to water undertakers' conditions of appointment.
3. Modify conditions of appointment to ensure that all or most new competition arrangements between water undertaker and licensee are covered by means of a condition of appointment.

Option 1

The WIA91 provides a basic legislative framework for the licensing regime and provides for Ofwat to modify water undertakers' conditions of appointment to enable a more effective implementation of the new regime.

If Ofwat made no changes to water undertakers' conditions of appointment, it is likely that regulatory uncertainty would increase. For example, there are provisions in the WIA91 that require a water undertaker to follow Ofwat's guidance on access terms and prices. However, there are no provisions to ensure that a water undertaker publishes its access code (including prices) and keeps it under review. This means that unless a water undertaker has an obligation to publish its code, Ofwat would not know whether such codes existed or whether water undertakers had in fact undertaken any work to calculate access prices in advance of being approached by a licensee.

Also, without published access codes, there would be uncertainty for prospective suppliers as they would have difficulty assessing the costs and benefits of applying for a Water Supply Licence. There may not be information available setting out the terms on which they could enter into agreement with a water undertaker.

Although the access agreement between a licensee and a water undertaker will be case specific and to some extent depend on the circumstances of the agreement, it is important that a water undertaker has in place an access code that can then be tailored to meet the licensee's circumstances.

Similarly, without appropriate changes to conditions of appointment, there would be no obligation on water undertakers to plan in advance and ensure they have systems and procedures in place to ensure the smooth transfer of a customer to another supplier. This would have detrimental effects on competition since it would not ensure a level playing field with all water undertakers acting in the same way.

If there are no clear duties set out in water undertakers' conditions of appointment to complement the licensing provisions of the WIA91, prospective suppliers may be deterred from entering the competitive market. And in order for water undertakers to be able to plan future activities effectively, they need to know exactly what is expected of them under the new licensing provisions.

This option would make it more difficult for Ofwat to promote competition. And it is likely that Ofwat would become more involved in disputes that could otherwise have been avoided if specific provisions were set out in the water undertakers' conditions of appointment (for example regarding customer transfer issues where there would be inconsistencies in approach taken by water undertakers).

Option 2

This option will increase regulatory certainty and will create clarity to ensure that water undertakers are aware of what is expected of them to make the regime work.

There will also be clarity for licensees about the duties of water undertakers and how these impact on any agreements entered into between the two parties.

This option will enable the water undertaker to plan effectively for implementing the licensing provisions, including developing their internal policies and procedures where necessary.

We believe this option will produce the right balance of clarity and flexibility.

Putting only the most appropriate requirements in conditions of appointment leaves water undertakers with some flexibility to deal with other contractual and customer specific issues in an access agreement. Subject to compliance with the requirements of Ofwat's statutory guidance, this has the advantage that water undertakers and licensees will have discretion to decide what works best for them according to the specifics of their arrangement. This would reduce the need for regulatory intervention that might otherwise arise if there was little flexibility in the terms and licensees felt that water undertakers were being inflexible to prevent market entry. However, in allowing greater flexibility there will need to be a balance to ensure that parties do not have so much discretion that they then have difficulty agreeing terms and call on regulatory intervention.

This option means that only minimal changes are made to water undertakers' existing conditions of appointment. This differs to option 3 where all issues would be dealt with in the conditions of appointment.

The access agreement between a water undertaker and licensee will govern case specific issues such as how the parties intend to deal with customer queries and complaints, emergency procedures and contacts, certain water quality issues, billing and debt collection. Ofwat guidance on access terms (including prices) will guide water undertakers and licensees as to what issues should be considered when drawing up access agreements. If these terms were contained in conditions of appointment, it would be more difficult and costly to modify the condition every time a change was required.

Option 2 is the preferred option that frames our approach in this consultation paper, as it creates the least regulatory uncertainty for water undertakers and has the least impact on costs.

Option 3

This option would mean that almost all issues that could otherwise be dealt with through an access agreement would instead be dealt with in the form of conditions of appointment. The modifications made to water undertakers' Instruments of Appointment would apply to all water undertakers (rather than being company specific).

Water undertakers and licensees would know exactly what was expected of them since everything would be specified in the conditions of appointment. However, this may place an unnecessary burden and cost on water undertakers. For example, if all issues were listed in conditions of appointment, then a water undertaker would be more likely to have to ensure that every agreement that was entered into with a licensee covered these issues (regardless of whether the circumstances of the agreement required this). It would be costly for a water undertaker having to comply

with its conditions of appointment when it was not essential for the agreement in question. If the water undertaker did not ensure this, it would be in breach of an appointment condition.

Option 3 is more prescriptive with limited potential flexibility for water undertakers to tailor their agreements with licensees to reflect case specifics. In regulatory terms, if we wanted to change any aspect of supply arrangements, it would be far more difficult to make changes to conditions of appointment than it would be to change our guidance that would inform access agreements.

Under this option, Ofwat would incur greater costs of regulating and monitoring water undertakers' policies, and ultimately prices could rise for customers. In any event, the WIA91 envisages a balance between modifications to water undertakers' appointment conditions and guidance on access terms and conditions.

2.2 Standard conditions for licensees

In creating standard licence conditions for licensees, we have identified the following options:

1. Have no standard licence conditions, or a few that were very limited, but prescribe in the access code guidance what licensees should do.
2. Have the most appropriate number of standard licence conditions in order to cover the main issues, with flexibility to deal with case specific matters in an access agreement.
3. Prescribe most things by means of standard licence conditions.

Option 1

This option is likely to increase regulatory uncertainty. For example, a licensee would not be under a duty to provide Ofwat and the appropriate water undertaker with relevant information in a manner, which was enforceable by Ofwat. There would, therefore, be a greater risk of the regime not working effectively.

Without an obligation to comply with the Transfer Protocol as a licence condition, there would be detrimental effects on competition since Ofwat would not have any powers to ensure the licensee acted fairly or prevent it from restricting competition.

Licensees would have a greater degree of flexibility to do what they wanted and could therefore act inappropriately without the risk of having their Water Supply Licence revoked.

Subject to compliance with Ofwat's statutory guidance, this option would mean greater flexibility for water undertakers and licensees and could therefore lead to greater inconsistencies in approaches taken, such as in the transfer of a customer. This could prove detrimental to the implementation of competition and could impact on the service customers received.

This option would also introduce greater risks to eligible customers. Eligible customers might be deterred from switching from a water undertaker to a licensee, due to the greater risks involved as a result of the limited enforcement powers which Ofwat would have. In any event, the WIA91 envisages a balance between licence conditions and guidance on access terms and conditions.

Option 2

We believe this option will produce the right balance of clarity and flexibility. The most important and central issues which need to be enforceable directly by Ofwat would be covered through standard licence conditions. Water undertakers and licensees would still retain a degree of flexibility to deal with case specific matters through an access agreement (subject to compliance with Ofwat's statutory guidance).

The standard licence conditions that are proposed for licensees are detailed in the consultation paper and include duties to ensure that the licensee co-operates with the water undertaker and Ofwat by complying with reasonable requests for information. Licensees will also be under a duty to comply with a customer Transfer Protocol (to be developed by Ofwat in conjunction with the industry via advisory groups).

The access agreement between a water undertaker and licensee will govern case specific issues such as: how the parties intend to deal with customer queries and complaints; emergency procedures and contacts; certain water quality issues; billing; and debt collection. Ofwat guidance on access terms (including prices) will guide water undertakers and licensees as to what issues should be considered when drawing up access agreements. If these terms were contained in standard licence conditions, it would be difficult and costly to modify the condition every time a change was required. And in any event, the WIA91 envisages a balance between licence conditions and guidance on access terms.

Risks to the network and customers will be limited by requiring potential licensed suppliers to ensure that they are competent to enter the market and comply with their legal obligations and standard licence conditions.

This is our preferred option. This approach would give more reassurance to customers and water undertakers as standard licence conditions will set out obligations of the licensee and instances where they can be called to account.

Option 3

This option would mean that most issues that could otherwise be dealt with through an access agreement, would, instead be imposed on licensees in the form of standard licence conditions.

However, it may place an unnecessary burden and cost on licensees. For example, if all issues were listed in standard licence conditions, then a licensee would be under a duty to comply with these requirements in all dealings with water undertakers. This would reduce the scope for flexibility to respond to the

circumstances of individual access agreements. It would be costly for a licensee having to comply with its standard licence conditions when it was not essential for the supply in question. For example, we could include standard licence conditions to cover specific levels of service criteria that a licensee should meet when providing services to its customers regardless of whether its customers required the specified service levels.

By putting most requirements in standard licence conditions, Ofwat would incur greater costs of regulating and monitoring licensees' activities. This is because Ofwat would need to collect more information from licensees and spend more time assessing this on an ongoing basis to ensure licensees were complying with their conditions and providing the required services. Also, by maximising the number of standard licence conditions, this could potentially increase the amount of time spent by Ofwat investigating trivial breaches of those conditions. This would impose more regulatory costs on Ofwat, which ultimately could lead to price rises for customers.

Option 3 would be too prescriptive with limited flexibility for licensees to tailor their agreements with water undertakers to reflect case specifics. In regulatory terms, if we wanted to change any aspect of supply arrangements, it would be far more difficult to make changes to standard licence conditions than it would be to change the guidance that would inform access agreements. In any event, the WIA91 envisages a balance between licence conditions and guidance on access terms and conditions.

3. Summary of costs and benefits to support the adoption of Option 2

This section provides a summary of the costs and benefits already identified in this RIA associated with the adoption of Option 2 in this consultation paper, for water undertakers and licensees. This section is intended to verify the reasons why we favour Option 2.

3.1 Benefits

This section summarises the expected benefits of supporting Option 2.

Benefits to water undertakers / licensees

- It enables water undertakers/licensees to plan policies to implement the licensing provisions more effectively.
- It reduces uncertainties for water undertakers/licensees, by clearly setting out key duties that should be complied with.
- It will enable water undertakers/licensees to reduce some costs in the long term as they will be aware of their obligations prior to agreeing any terms of access.

- It provides clarity to those interested in entering the competitive market. A prospective supplier will be provided with details of standard licence conditions that will need to be adhered to if its licence application is successful.

Benefits to customers

As the approach allows some flexibility to water undertakers and licensees to secure customer specific arrangements, customers' needs can be better accommodated than through the other options. Having too many prescriptive licence conditions might be seen as a barrier to entry by licensees, thus reducing the number of new suppliers that customers can choose from.

Benefits to Ofwat

- Our proposed approach improves the transparency of regulation.
- It allows us to maintain some control over licensees' activities without being too prescriptive.
- It reduces the risks that water undertakers, licensees and customers would otherwise face if we adopted a 'hands-off' approach.

3.2 Costs

This section summarises the expected costs of supporting Option 2.

Costs to Ofwat

Ofwat expects that there will be some increased costs to administer both the new obligations we are proposing for water undertakers as well as the new standard licence conditions for licensees. Although these costs are difficult to quantify at this stage, they will for example relate to assessing and analysing information provided by the licensee, which will be requested to enable Ofwat to fulfil its functions under the WIA91. There will also be costs involved in instances where we have to take enforcement action if licence conditions are breached.

Section 17G WIA91 allows for payment of a licence fee on the grant of a Water Supply Licence, and/or payments while such a licence is in force. Any net increases in Ofwat's expenditure arising from the proposals on competition would ultimately be recovered from the fees paid by water undertakers and licensees where appropriate.

The new competition regime will create additional regulatory functions for Ofwat. This will include monitoring and enforcing the carrying out of water undertakers' obligations to provide access and wholesale supplies, including pricing and managing the additional complexity of regulating water undertakers in the context of more competition. There will also be additional regulatory functions for monitoring and enforcing the carrying out of licensees' obligations to co-operate with water undertakers and Ofwat.

Costs to water undertakers

There will be minimal costs for water undertakers in implementing the proposals we have outlined in the consultation paper. As an example, a water undertaker will incur costs in revising its access code as well as costs associated with publishing the code and keeping it under review. There may also be costs involved in complying with a Transfer Protocol, such as ensuring that they have the appropriate procedures in place to ensure the smooth transfer of a customer.

Costs to licensees

Section 17G WIA91 allows for payment of a licence fee on the grant of a Water Supply Licence, and or payments while such a licence is in force.

Fees will be set at a level to recover Ofwat's and the Competition Commission's costs in regulating the competitive market. The fees will ensure that ineligible customers will not be subsidising the regulatory costs of the new licensing regime through water undertakers' appointment fees.

4. Questions

We welcome your views on this partial RIA, in particular on the following:

Q1: Do you consider that our analysis of the benefits and costs of the approach we have taken in the consultation is complete? If not, please explain why.

Q2: What other benefits or costs do you feel should be included? If possible please quantify these.